No. 371

# In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

*v.*

JOHN H. SMITH, *Respondent*

## RESPONDENT'S BRIEF OPPOSING PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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The Commissioner of Internal Revenue, through the Solicitor General, has petitioned for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit. The Respondent opposes the granting of such a writ.

## OPINIONS BELOW

The memorandum opinion of the Tax Court (R.21-37) is not officially reported but included in the Record. Opinica of the Circuit Court of Appeals is reported in 142 *Fed.* (2) 818.

The jurisdiction of the Court, the statutes and regulations involved, are stated in the petition for the writ of certiorari.

## QUESTION PRESENTED

Whether, upon the receipt of stock purchased under an option which was granted to the Respondent in an earlier year as compensation for personal services performed prior to the date of the option, and where the option price was equal to or in excess of the then market value, the Respondent realized taxable income within the meaning of *Section 22*(a) *of the Revenue Act of* 1938 for any excess values accruing to the stock after the giving of the option.

## STATEMENT

The Respondent calls this Court's attention to the following additional facts:

A reorganization of Hawley Pulp and Paper Company was had under the provisions of Section 77(b) of the Bankruptcy Act, under the terms of which Western Cooperage Company was to manage the Hawley Pulp and Paper Company (R. 46, 47). Under the provisions of the reorganization indenture Western Cooperage Company had the right to acquire, upon compliance with certain conditions, certain voting trust certificates representing the common stock

of Hawley Pulp and Paper Company (R. 50, 65, 66). At the time the option was given to John H. Smith on December 10, 1934, Western Cooperage Company did not own the stock of Hawley Pulp and Paper Company but only had the right to receive such stock under the terms of the reorganization indenture.

The option given to John H. Smith on December 10, 1934, was in consideration of services which had been *theretofore* rendered (R. 74, 83, 86). The purchase price was fixed at ten cents per share on the common stock, which was equal to or in excess of the market value at the time of the giving of the option (R. 90, 92, 101, 102, 118-121, 130).

The option agreement (R. 82-86) runs not only to John H. Smith, but to his heirs or assigns.

In the years 1940 and 1941 the Respondent John H. Smith sold part of the common stock which he had received and reported the profit thereon in his income tax returns for the respective years of 1940 and 1941, taking as a basis for the computation of profit the amount of ten cents per share which he had paid as the agreed price for said stock under said option (R. 93, 94, 95).

His future employment by Western Cooperage Company did not depend upon the option (R. 95).

## ARGUMENT

The petition for writ of certiorari asserts that the decision below is in conflict wih the decision of the Circuit Court of Appeals for the Sixth Circuit in *Connolly's Estate* vs. *Commissioner*, 135 *Fed.* (2d) 64. The facts in the Connolly case are substantially different from those in the present case. The differences which appear in the Connolly case are as follows:

(a) At the time the options were granted the market value of the stock was nearly two and one-half times the option price;

(b) The employer in the Connolly case had voluntarily reduced the fixed salaries of certain employees, including Connolly, during a five-year period preceding the time of the granting of the options, and the designated employees, including Connolly, were then serving the corporation at a rate of fixed compensation greatly disproportionate to the value of their services;

(c) The option entitling the employees to purchase at a price less than the market value was given as adjusted compensation for services "heretofore rendered, and as an inducement to said Messrs. Hoagland and Connolly to continue in the employ of the corporation";

(d) The resolution revising the terms of the op-

tions recited that the revision was necessary if Hoagland and Connolly, through the medium of options, were to receive purchase rights which "in any real sense" would constitute compensation for valuable services theretofore and then being currently rendered by them to the corporation;

(e) The minutes of the corporation also recited that the services rendered had greatly exceeded in value any compensation received by them, and that the best interests of the corporation would be served by the "continued willingness of these persons to serve the corporation and to exercise in the administration of its affairs the same degree of time, effort and skill as heretofore, and as an inducement to that end," the Board of Directors granted the options "by way of adjusted compensation."

In other words, the parties in the Connolly case recognized that there was a value in excess of market value, and that such excess was in the nature of compensation for services being presently rendered and to be rendered in the future.

In the case below, Western Cooperage Company and John H. Smith arrived at an option price which was equal to or in excess of the then market value. There was no excess value at the time of the option. The option itself was the only thing given as compen-

sation for services which had been rendered prior to the time of the option. None of the parties intended that any excess values subsequently accruing should be compensation (R. 92). This intention is borne out by the fact that the Respondent John H. Smith has already paid his tax on the gains produced by the sale of part of this stock in 1940 and 1941, using as his basis the sum of ten cents per share, the agreed sale price under the option.

The option itself ran to Mr. Smith, his heirs or assigns. If he had died before exercising the option his heirs could have exercised the same and certainly the excess values would not be considered as compensation to such heirs. Mr. Smith could have sold the option and the excess value certainly would not have been considered compensation to his assigns.

This case below was determined in accordance with the weight of authority as expressed by the several Circuit Courts of Appeal in the following cases:

*Bothwell* v. *Commissioner*, 10 *Cir.*, 77 *F. 2d* 35; *Rossheim* v. *Commissioner*, 3 *Cir.* 92 *F. 2d* 247; *Hawke* v. *Commissioner*, 9 *Cir.* 109 *F. 2d* 946. See also *Gardner-Denver Co.* v. *Commissioner*, 7 *Cir.*, 75 *F. 2d* 38; *Omaha Nat. Bank* v. *Commissioner*, 8 *Cir.*, 75 *F. 2d* 434.

The legal question involved here is substantially

the same as that where stock of a corporation is sold to a stockholder. Such a question arises under the same section of the statute, and it is significant that *Treasury Regulations* 101, promulgated under the Revenue Act of 1938, *Article* 22(a)-1, contemplate both kinds of transactions under one regulation.

This Court has already ruled in the case of *Palmer* v. *Commissioner of Internal Revenue*, 302 *U. S.* 63, 82 *L. Ed.* 50, that such purchases by stockholders from a corporation, even though under options or rights, are not compensation where the option price is equal to or in excess of the then market value.

The Respondent respectfully submits that this cause gives no rise to an issuance of a writ of certiorari and that there is no conflict between the decision below and the decision of the Sixth Circuit Court of Appeals. This question has already been decided uniformly by the Circuit Court of Appeals in all cases that have comparable facts, and substantially the same question has been decided by this Court.

## CONCLUSION

Respondent respectfully submits that the petition for writ of certiorari should be denied.

Respectfully submitted,

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